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In the Supreme Court of the United States

OCTOBER TERM, 1934

No. 17

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

LELAND POWERS, EXECUTOR, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 57–60) is reported in 68 F. (2d) 634. The findings of fact and opinion of the Board of Tax Appeals (R. 17–29) are reported in 26 B.T.A. 1381.

JURISDICTION

The judgment of the court below was entered January 9, 1934 (R. 60–61). The petition for writ of certiorari was filed April 9, 1934, and was granted May 14, 1934 (R. 61). The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the income received by the taxpayers as trustees of the Boston Elevated Railway Company was exempt from Federal taxation on the ground that such a tax would be an unconstitutional burden on the State.

STATUTES AND REGULATIONS INVOLVED

The Federal statutes and regulations involved are set forth in Appendix A (*infra*, pp. 34–35). The material portions of the Special Act of the Massachusetts Legislature providing for the public operation of the Boston Elevated Railway Company are set forth in Appendix B (*infra*, pp. 36–45).

STATEMENT

The facts as found by the Board of Tax Appeals (R. 18–21) may be summarized as follows:

Prior to 1926 the taxpayers were appointed trustees of the Boston Elevated Railway Company under the provisions of Chapter 159 of the Special Acts of 1918 of the Commonwealth of Massachusetts, "An Act to Provide for the Public Operation of the Boston Elevated Railway Company." The material portions of this Act are set out in Appendix B, *infra*.

Under this Special Act the State, with the consent of the company, took over the management and operation of the railway and the properties of the company in return for guaranteed dividends on its stock and interest on its obligations. The

property remained at all times that of the company, the State taking over only the management and operation, which was to continue for a period of ten years or such extended period as might be determined. There was created a board of trustees, consisting of five persons to be appointed by the Governor with the advice and consent of the Executive Council, to manage and operate the railway and to hold possession of the properties of the company on behalf of the State during the period of public operation. The trustees were appointed for a term of ten years and it was provided (Sec. 1) that each should receive "from the company" an annual salary of $5,000. The trustees were vested with all the rights and powers of the company and its directors; were authorized upon behalf of the company to receive and disburse its income and funds and to determine the service and facilities to be furnished, in which latter respects their authority was exclusive of control by any other state board or commission. It was provided that the trustees should not be considered public officers for certain purposes (Sec. 1), and in the management and operation of the company and its properties they should "be deemed to be acting as agents of the company and not of the commonwealth, and the company shall be liable for their acts and negligence in such management and operation to the same extent as if they were in the immediate employ of the company" (Sec. 2).

The trustees were authorized to fix such rates of fare as reasonably necessary to produce sufficient income to meet the cost of service including therein, among other items referred to, dividends on the stock. Out of the three million dollars to be raised in cash by the company from the sale of preferred stock, the trustees were to set up a reserve fund of a million dollars to pay the cost of service when revenues were inadequate, with provisions that, semiannually, any deficiency in the reserve fund for that purpose would be supplied by the State and at like periods any excess of the reserve fund over the original amount should be applied to reimburse the State for amounts paid to the company. The remaining two million dollars were subject to the disposition of the trustees to pay for the cost of additions and improvements to the company's property (sec. 5). Such amounts as the State might be required to pay the company were to be obtained by assessment, in addition to state taxes, proportionately upon the cities and towns served by the company and any excess revenues repaid to the State were to be distributed proportionately to such cities and towns. Upon termination of public management and operation the company was authorized to take over the management and operation. Upon resumption of private operation the company was to fix and collect such reasonable fares as would produce sufficient income to pay the cost of service, to the same extent as the trustees were so authorized, with

authority also to establish schedules of fares automatically increasing or decreasing in the same manner as authorized in the case of the trustees. After the return of control to the company, however, the State no longer was obligated to supply any deficiency in income. It was provided that public regulation and supervision of the company after resumption of private operation should not be exercised so as to reduce the income below the reasonable cost of service as defined, which included dividends on stock and interest on obligations.

In 1929 a deficiency of $3,980,151.67 was incurred from public operation of the railway, which amount the State obtained by apportionment among the cities and towns served and paid it to the company in accordance with its obligation under the Act. The excess revenues from operations up to and including 1929 were insufficient to fully reimburse the State and cities and towns for the sum so paid.

During the respective taxable years, each taxpayer was a trustee of the Boston Elevated Railway and received a salary of $5,000 per year, under the Special Act. The Commissioner determined that the salary so received by each taxpayer was taxable income and asserted a deficiency against each taxpayer for the respective years. The taxable years involved are 1926 to 1929, inclusive (R. 17).

The Board of Tax Appeals sustained the Commissioner (R. 29), but its decision was reversed by the Circuit Court of Appeals (R. 60).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the taxpayers as trustees of the Boston Elevated Railway Company, having been appointed under a Special Act of the Massachusetts legislature, providing for public management and operation of the railway properties, were exercising essential governmental functions of the State and hence their salaries were exempt from Federal taxation.

2. In holding that the compensation received by the taxpayers as such trustees was not subject to the Federal income tax.

3. In holding invalid the provisions of Article 88 of Treasury Regulations 69.

4. In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

I

The statute imposes a tax upon the income of every individual derived from compensation for service and from all sources whatsoever. The court below held that the respondents, as trustees of the railway, exercised essential governmental functions of the Commonwealth of Massachusetts and accordingly, under the Treasury Regulations, their compensation was exempt from taxation. The court also held that regardless of the nature

of their functions the respondents were officers of the State and that their compensation as such officers was exempt from the Federal income tax.

The doctrine of implied constitutional immunity from taxation by the Federal Government of the agencies and instrumentalities employed by a State is limited to those exercising strictly governmental functions of the State. In determining the extent to which the doctrine applies, the reason for the rule must control and the exemption must depend finally upon the effect of the tax upon the exercise by the State of its essential functions of government, although consideration should also be given to the inherent nature of the agency, and its relation to government.

The respondents were trustees of the railway appointed under the Special Act of the Legislature of Massachusetts by which, upon acceptance by the company, the State took over the management and operation of the railway. The trustees were appointed solely for the purpose of managing and operating the railway and to the end that adequate transportation service might be maintained were authorized to fix rates of fare sufficient to meet the cost of service. Under the agreement, the State obligated itself to advance to the company any deficits incurred in the cost of operation, such deficits to be raised by taxation. Any sums advanced by the State, however, were to be repaid from any excess revenues realized from operation.

It is no part of the essential governmental functions of a State to furnish means of transportation to its people. By assuming the management and operation of the railway the State of Massachusetts exercised no essential power of government but embarked upon a venture of a purely private character. When a State departs from the essential functions of government and engages in a business or activity of a purely private nature, it and the instrumentalities employed therein are subject to a nondiscriminatory tax imposed by the Federal Government. Since the assumption of the management and operation of the railway by the State was not a governmental power, it follows necessarily that the respondents as trustees were not agents or instrumentalities exercising essential powers of government of the State. Accordingly, the compensation received by the respondents as trustees, which compensation was paid by the company and not the State, is not within the appropriate scope of the doctrine of implied constitutional immunity and is subject to the Federal income tax.

II

The provisions of the regulations as to the compensation of "officers" are valid and are applicable in this case. The court below held that the trustees were officers of the State and that there is no basis for the requirement of the regulations that the compensation must be received for services

rendered in the exercise of governmental functions. In so holding, the court either ignored or overlooked explicit and well-known decisions of this Court. *Flint* v. *Stone Tracy Co.*, 220 U.S. 107; *South Carolina* v. *United States*, 199 U.S. 437; *Ohio* v. *Helvering*, 292 U.S. 360.

III

The fact that the respondents had the power to fix rates and to declare deficits which were used as a basis of taxation is not sufficient to exempt from taxation the salaries which they received for managing the railroad. The respondents had no discretion in fixing rates, and they had no power to levy taxes. Their authority with respect to each was merely ministerial.

Moreover, the compensation received by the respondents was not paid for the exercise of these powers. The salaries were paid to the trustees *by the company* and not by the Commonwealth, and they were paid for their services as managers of the company. If the respondents exercised any essential governmental powers, they received no compensation on that account; and their compensation received for other services is not exempt.

Even if the salary paid by the company could be regarded as paid in part as compensation for essential governmental powers exercised by the respondents on behalf of the State, it would not follow that the entire amount of the compensation would be

exempt from Federal tax. If it is necessary or proper to allocate the compensation actually received, the respondents must fail, for they have produced no evidence of the proper basis of allocation. The fact that such an allocation would be difficult to make does not furnish any basis for the respondents' contention that the entire salary should be exempt.

ARGUMENT

The Circuit Court of Appeals held that the taxpayers were public officers exercising essential governmental powers of the Commonwealth of Massachusetts and accordingly that their compensation is exempt from Federal income taxation under the Treasury Regulations. It was also held that in any event the Federal Government is without power to tax the compensation paid to the taxpayers as public officers of the Commonwealth, regardless of the nature of the functions they exercised. The petitioner contends that the taxpayers were agents or officers exercising a proprietary, and not a governmental, function of the State, and that their compensation is not exempt from Federal taxation either under the Treasury Regulations or under the principle of immunity of the instrumentalities of one government from taxation by another. The Special Act provided that in the management and operation of the railway the respondents should be deemed to be acting as

agents of the company and not of the Commonwealth and they were paid as such agents by the company for managing the railroad.

I

THE OPERATION OF A STREET RAILWAY SYSTEM IS NOT AN ESSENTIAL FUNCTION OF A STATE

The doctrine, resulting from our dual system of government, that the agencies, means, and instrumentalities through which a State exercises its essential governmental powers are immune from taxation by the Federal Government, and that those of the Nation are similarly exempt from state taxation, has long been established. *McCulloch* v. *Maryland,* 4 Wheat. 316; *Osborn* v. *Bank,* 9 Wheat. 738; *Dobbins* v. *Commissioners of Erie County,* 16 Pet. 435; *The Collector* v. *Day,* 11 Wall. 113; *United States* v. *Railroad Co.,* 17 Wall. 322; *Ambrosini* v. *United States,* 187 U.S. 1; *Indian Motocycle Co.* v. *United States,* 283 U.S. 570, 575. In *Fox Film Corp.* v. *Doyal,* 286 U.S. 123, 128, this Court, in pointing out that this principle of immunity from taxation has its inherent limitations, said:

> It is aimed at the protection of the operations of government (*McCulloch* v. *Maryland,* 4 Wheat. 316, 436), and the immunity does not extend "to anything lying outside or beyond governmental functions and their exertions." *Indian Motocycle Co.* v. *United States,* 283 U.S. 570, 576, 579.

> Where the immunity exists, it is absolute, resting upon an "entire absence of power" (*Johnson* v. *Maryland*, 254 U.S. 51, 55, 56), but it does not exist "where no direct burden is laid upon the governmental instrumentality, and there is only a remote, if any, influence upon the exercise of the functions of government" *Willcuts* v. *Bunn*, 282 U.S. 216, 225.

See also *Trinityfarm Co.* v. *Grosjean*, 291 U.S. 466, 472. As this Court said in *Willcuts* v. *Bunn*, *supra*, (p. 225):

> The limitation of this principle to its appropriate applications is also important to the successful working of our governmental system.

The immunity does not extend to every activity upon which a State may embark but is limited to those of a strictly governmental character. Only those instrumentalities through which the State *directly* and *immediately* exercises its essential powers of government are exempt from Federal taxation. *Metcalf & Eddy* v. *Mitchell*, 269 U.S. 514. Where the State engages in a business or performs acts of a private nature, it and the agencies through which it acts are subject to the power of taxation vested by the Constitution in Congress. *Ohio* v. *Helvering, supra; South Carolina* v. *United States, supra.*

In the *South Carolina* case, this Court held that since the State was not exempt from the tax, the taxing statute reached the individual sellers who

acted as dispensers for the State. So in the case at bar, even if the State had owned the railway company, the company would not have been exempt from taxation by the Federal Government. And certainly the fact that the State operated the railway under a lease arrangement, did not exempt the railway from Federal taxation, and as held in the *South Carolina* case, the statute likewise reached the individual trustees who acted in a sense for the State, but were in the language of the Special Act, the agents of the company and not of the Commonwealth. They cannot claim an exemption which their principal could not claim.

Here the railway company, a private corporation, was the instrumentality used by the State to operate the railroad. The State leased the railroad and the corporation continued in existence, its property was by the explicit provisions of the Special Act subject to taxation by the State, and also subject to suits for damages resulting from the negligence of the trustees and the other agents and employees of the company. The railway company continued to have a president and other officers, and a board of directors which was not removable by the board of trustees (Sec. 2).

Admittedly in the operation of the railroad, the State was not exercising any of its sovereign or essential powers of government, but embarked upon a private enterprise, and as the instrumentality was not immune from either State or Federal taxation, the compensation which the agents received from

the company for their services in managing and operating this private enterprise, is not immune from taxation. When the instrumentality is one which exercises an essential governmental function, the immunity extends not only to the instrumentality itself, but to income derived from it.

> When, however, the question is approached from the other end of the scale, it is apparent that not every person who uses his property or derives a profit, in his dealings with the government, may clothe himself with immunity from taxation on the theory that either he or his property is an instrumentality of government within the meaning of the rule.
>
> [*Metcalf & Eddy* v. *Mitchell*, *supra* (522).]

As this Court said in the *Indian Motocycle Co.* case, *supra* (p. 576)—

> Where a State departs from her usual governmental functions and "engages in a business which is of a private nature", no immunity arises in respect of her own or her agents' operations in that business.

It is doubtless impracticable to formulate any comprehensive rule for determining what agencies of a State are exempt from Federal taxation, especially in close cases falling between the two extremes of governmental and private operations where it is necessary to separate those activities having some relation to government which are subject to taxation from those which are exempt. The reason for the principle of immunity, how-

ever, must control its operation. Under our system the Federal Government must exercise its authority within the States, and while there may be no *undue* interference by one government with the exercise by the other of its powers, taxation by either necessarily and unavoidably has some effect upon the other. Accordingly, the doctrine of immunity of a State and its instrumentalities from taxation by the Federal Government calls for a practical test which allows the State to discharge its functions with a minimum of interference, and the principle must not be so extended as seriously to impair the taxing power of the Nation. While consideration should be given to the nature of the governmental agency in determining the question of tax exemption, the extent to which the doctrine is applicable depends finally upon the effect of the tax upon the State's essential powers of government. *Metcalf & Eddy* v. *Mitchell, supra* (pp. 522–524).

The obvious purpose of the special legislation was to substitute public operation and control of the railway for the private management and to fix rates of fare sufficient to meet the cost of service to the end that adequate service might be maintained. The State, however, did not substitute public ownership of the railway for private ownership. The railway remained the property of the company, a private corporation operated for private profit. The company has outstanding bonds and stocks and

the Special Act made it the duty of the trustees to pay the interest on the bonds and to pay dividends on both the preferred and common stock. (Secs. 3, 6, 11; *infra*, pp. 39, 42. See also Sec. 15, *infra*, p. 44.) It was expressly provided (Sec. 2, *infra*, p. 37) that in the exercise of the powers conferred the trustees should "be deemed to be acting as agents of the company and not of the commonwealth." While the State undertook to supply such funds as might be required by a deficiency in income to meet the cost of service, the Act provided for reimbursement of the State for any sums advanced (Sec. 11, *infra*, p. 42), and the State is to receive any surplus in the reserve fund at the termination of public operation (Sec. 13, *infra*, p. 43). It is plain that in thus providing for public *operation* of the railway the Commonwealth of Massachusetts was not exercising any essential governmental function, but was merely lending its aid to a private enterprise. True the railway was affected with a public interest, in that the facilities furnished for transportation were for the convenience and comfort of the people of the communities served by the railway. But the railway was not an instrumentality of government and the operation of the railway was not an essential governmental function or activity.

The Special Act under which the State assumed the operation of the railway through trustees, after acceptance by the company, was in effect a lease of the railway for an adequate consideration.

Opinion of the Justices, 231 Mass. 603, 609; *Boston v. Treasurer & Receiver General*, 237 Mass. 403, 413; *Opinion of the Justices*, 261 Mass. 523, 541. If the State had taken title to and acquired ownership of the railway company and its properties and operated the same it would not have thereby exercised any of the powers essential to government. Much less then can it be said that the mere operation of this public utility by the State through duly appointed agents under a lease is a discharge of any of the State's functions of Government.

This Court has said in unequivocal and unqualified terms, in considering taxation of public utility companies, that:

> It is no part of the essential governmental functions of a State to provide *means of transportation,* supply artificial light, water, and the like.
>
> These objects are often accomplished through the medium of private corporations, and, though the public may derive a benefit from such operations, the companies carrying on such enterprises are, nevertheless, private companies, whose business is prosecuted for private emolument and advantage. * * *
>
> The true distinction is between the attempted taxation of those operations of the States essential to the execution of its governmental functions, and which the State can only do itself, and those activities which are of a private character. The former, the United States may not interfere with by tax-

> ing the agencies of the State in carrying out its purposes; the latter, although regulated by the State, and exercising delegated authority, such as the right of eminent domain, are not removed from the field of legitimate Federal taxation. [*Flint* v. *Stone Tracy Co.*, *supra* (p. 172). (Italics ours.)]

As the assumption by the State of the management and operation of the railway was for public purposes, the State had the power to levy taxes for the purpose of maintaining this transportation service. *Boston* v. *Treasurer & Receiver General*, *supra*; *Boston* v. *Jackson*, 260 U.S. 309, 315. But the power exercised by the State to maintain this service for public purposes was not governmental. The terms "public purpose" and "governmental purpose" are not synonymous. *State of North Dakota* v. *Olson*, 33 F. (2d) 848, 852 (C.C.A. 8th), dismissed for want of jurisdiction, 280 U.S. 528; 2 Cooley, Taxation (4th ed.) Sec. 639.

The management and operation of the railway by the State was no less a private venture than the control of the liquor traffic by the States of Ohio and South Carolina through state-owned dispensaries and appointed agents. Ohio and South Carolina each took over control of the liquor traffic in furtherance of a state policy and for public purposes, for the general welfare and in the interest of the people of the State. Those States, however, and the agencies employed for such purposes were held subject to the Federal tax imposed upon per-

sons engaged in the liquor business, because, notwithstanding the public purpose served, the sale of liquor by the States was a private enterprise and not a function of government. *Ohio* v. *Helvering, supra; South Carolina* v. *United States, supra.* Similarly, notwithstanding the public purpose accomplished, the Commonwealth of Massachusetts by assuming the management and operation of the railway entered upon a purely private enterprise and was not exercising any of its ordinary powers of government.

Under the principle of the *Ohio* and *South Carolina* cases, had the State not only operated but also owned the railway, it would have been subject to a Federal tax upon that business. Indeed, the State itself recognized that it was not exercising any of its normal functions of government, for in Section 2 of the Act (*infra*, p. 37) it provided that the company and its stockholders should remain subject to taxation by the State and its subdivisions to the same extent as if the company managed and operated the railway. In *Boston Elevated R. Co.* v. *Malley*, 24 F. (2d) 758, 759 (Mass.), the court said:

> It would be a curious arrangement under which the corporation continued to be fully taxable as such for the benefit of the commonwealth, while it escaped taxation by the federal government.

See also *Group No. 1 Oil Corp.* v. *Bass*, 41 F. (2d) 483 (C.C.A. 5th), affirmed, 283 U.S. 279; *Wanless*

Iron Co. v. *Commissioner*, 29 B.T.A. 834. It was early determined that the company remained subject to Federal tax upon the business conducted, notwithstanding the absolute control of its properties by the State. *Boston Elevated R. Co.* v. *Malley*, 24 F. (2d) 758, 759 (Mass.); *Boston Elevated R. Co.* v. *Malley*, 288 Fed. 864 (Mass.). In the Act itself the State acknowledged that it was assuming the management and operation of a private business and did not regard such action as governmental.

It would seem to follow necessarily that the respondents as trustees of the railway were not essential governmental agencies or instrumentalities of the State. If, as the foregoing discussion seems to demonstrate, the State exercised no essential power of government in providing for the management and operation of the railway, then *a fortiori* the respondents as managers of the railway could not be agencies or instrumentalities exercising essential powers of government. Although the trustees were appointed under and their tenure and compensation were fixed by the Act, and they have been referred to as public officers, it is plain that they were not public officers in the sense of performing governmental duties. The Act provided that they should "not be considered public officers" for certain purposes (sec. 1) and as has been pointed out, the Act itself expressly declared that in the management and operation of the railway the trustees should be deemed to be acting as agents

of the company and not of the State. Section 2; *infra*, p. 37. The trustees were appointed for the purpose of managing and operating the railway; all contracts entered into and all acts performed by them were executed in the name of and on behalf of the company. At the most the trustees were the agents through which the State managed and operated the railway, a purely private business, and were not in anywise governmental instrumentalities of the State.

The tax imposed upon the compensation received by the respondents as trustees placed no burden upon the Commonwealth of Massachusetts. Although the salary of the trustees was fixed by the Special Act, the agreement between the State and the company, it was expressly provided that the compensation of the trustees should be paid by the company. See Section 1, *infra*, p. 36. The salary of the trustees was not paid by the State, and the Federal tax upon such income in nowise interfered with or affected the State in the establishment of agencies for the execution of its powers of government. It is true that under the agreement the State was obligated to advance the company any deficits incurred in operations, and for 1919 nearly $4,000,000 was paid by the State pursuant to the agreement. But, as the court below recognized, the amount so advanced was a debt of the company to the State, and it was contemplated that all sums advanced by the State to make up deficits should

be repaid. Moreover, there is nothing in the record to indicate that the company operated at a deficit during the years here involved (1926 to 1929, inclusive) or in any year other than 1919.[1] There is consequently no warrant for saying that the salaries of the respondents as trustees for the years in question were not paid by the company and the company alone.

The burden of the tax here in question falls solely upon the respondents individually. The Commonwealth of Massachusetts is not affected by the tax even indirectly, and certainly the taxation of the individual incomes of the respondents is not a direct interference with the exercise of any of the governmental powers of the State. It cannot be said that the imposition of this tax in anywise restricts the State in the full and free exercise of its sovereign governmental powers or lessens the power of the State to employ agencies or instrumentalities to execute its governmental powers. See *Miller* v. *McCaughn*, 27 F. (2d) 128 (C.C.A. 3d). Since, as this Court held in *Metcalf & Eddy* v. *Mitchell, supra*, the reason for the doctrine of implied immunity must be the guiding principle in determining its proper application, it seems clear that the

[1] The annual reports of the trustees for the years 1926 to 1929, inclusive, show that only in the year 1919 was any deficit incurred by the company which the State was called upon to pay. And the report for 1929 (p. 35) shows that prior to that year $2,630,818.32 of the advance for 1919 had been repaid to the State.

compensation received from the railway company by the respondents appointed to manage and operate the railroad as trustees is not within the appropriate scope of the rule of exemption and is subject to the Federal income tax.

The Circuit Court of Appeals recognized that by "classical standards" (R. 59) the management and operation of the railroad by the State was not an exercise of its essential powers of government, but questioned how long such standards would prevail in view of the tendency of government to extend its field of activity. In so doing, we submit, the court below has confused two wholly different questions: (1) the activities in which a State may engage if it chooses, and (2) the extent to which the State will be immune from Federal taxation if it engages in those activities. It was the very tendency to give a broad answer to the first of these questions which this Court relied on in *South Carolina* v. *United States, supra,* as requiring the limitation of immunity from taxation to those agencies and instrumentalities and activities of the State which are of a *strictly governmental* character. That this Court does not deem the expansion of the activities of government a justification for departing from "classical standards" in determining immunity from taxation, but rather considers such tendency as the imperative necessity for confining the doctrine of immunity within appropriate bounds and applying it only to those agencies through which

the State *directly* and *immediately* exercises powers of a strictly *governmental* character, is manifest from the recent decision in *Ohio* v. *Helvering, supra.*

Similar results have been reached in deciding closely related questions. Upon the authority of *Metcalf & Eddy* v. *Mitchell, supra,* this Court recently reversed *per curiam* two decisions of Circuit Courts of Appeals which held the compensation of an attorney employed by a State in special litigation and the compensation of an attorney employed by a municipality exempt from the Federal income tax. *Lucas v. Reed,* 281 U.S. 699; *Lucas* v. *Howard,* 280 U.S. 526. Those decisions have served largely to put at rest questions of the taxability of income received by a taxpayer from a State for services as special counsel or the like. See, e.g., *Burnet* v. *McDonough,* 46 F. (2d) 944 (C.C.A. 8th); *Lewis* v. *Commissioner,* 47 F. (2d) 32 (C.C.A. 3d); *Haight* v. *Commissioner,* 52 F. (2d) 779 (C.C.A. 7th), certiorari denied, 285 U.S. 537; *Register* v. *Commissioner,* 69 F. (2d) 607 (C.C.A. 5th). Similarly, in this case the respondents, although appointed by the Executive for specified terms, were not agencies created by the State to enable the State to perform a governmental function, but on the contrary they were appointed trustees to manage and operate the railroad, a nongovernmental activity, and were paid by the Railway Company; and their compensation received from the railway company is not exempt.

Two cases which seem contrary to our contentions should be referred to. In *Frey* v. *Woodworth*, 2 F. (2d) 725 (Mich.), it was held that the operation by a city of a municipally owned street railway was a governmental function and the compensation of an employee of the railway company was held to be exempt from Federal taxation. In *United States* v. *King County, Wash.*, 281 Fed. 686 (C.C.A. 9th), it was held that the operation of a county owned ferry was a governmental function and exempt from the Federal excise tax. In the light of the authorities referred to above, these cases, we submit, are unsound and cannot be deemed authoritative. In the *Woodworth* case, a writ of error taken by the Collector was dismissed on his motion (270 U.S. 669) for the reason that subsequent to the decision of the lower court the Revenue Act of 1926 was passed, providing in Section 1211 that "any taxes imposed by the Revenue Act of 1924 or prior revenue Acts upon any individual in respect of amounts received by him as compensation for personal services as an officer or employee of any State or political subdivision thereof * * * shall * * * be abated, credited, or refunded." No such statutory provision is applicable for the taxable years 1926 to 1929 inclusive here involved. *Commissioner* v. *Ogden*, 62 F. (2d) 334 (C.C.A. 1st), and *Jamestown & Newport Ferry Co.* v. *Commissioner*, 41 F. (2d) 920 (C.C.A. 1st), likewise rested upon express statutory exemptions.

II

THE PROVISIONS OF THE REGULATIONS AS TO THE COMPENSATION OF "OFFICERS" ARE VALID AND ARE APPLICABLE TO THIS CASE

Article 88 of Regulations 69 (*infra*, p. 35), promulgated under the 1926 Revenue Act, provides that the compensation paid to officers and employees of a State is exempt from income taxation only if received for services "rendered in connection with the exercise of an essential governmental function." Article 643 of Regulations 74 and 77, promulgated under succeeding Revenue Acts, is the same. Accordingly, the regulation has received the approval of Congress through reenactment of the statutory provisions upon which it is based. *United States* v. *Dakota-Montana Oil Co.*, 288 U.S. 459, 466. The regulation is plainly consistent with the statute, and we submit that it is a proper expression of the appropriate scope of the implied constitutional immunity of a State and its agencies from Federal taxation.

The court below, however, held that the trustees were officers of the State and that there is no basis for the requirement of the regulations that the compensation must be received for services rendered in the exercise of governmental functions (R. 59–60). In so holding the court either ignored or overlooked explicit and well-known decisions of this Court. The distinction made by the regu-

lations between state officers and employees exercising governmental powers and those employed by the State in carrying on some private venture for the public good is based upon principles established by this Court in *Flint* v. *Stone Tracy Co.*, *supra*, *South Carolina* v. *United States*, *supra*, and *Ohio* v. *Helvering*, *supra*.

It is plain from decisions of this Court and the lower Federal courts, as shown earlier in this brief, that only the agencies and instrumentalities of the State exercising essential functions of government are exempt from Federal taxation, and when the State engages in a private business both the State and the agencies it employs are subject to the taxing power of the Nation. Hence, the mere fact that the respondents, as trustees of the railway, were appointed by the State to serve as managers of the railway for 10 years is not sufficient to render their compensation immune from the nondiscriminatory Federal tax imposed upon the net income of every individual. Especially is this true, when the Act says they shall be deemed the agents of the railway company and paid by it. As trustees the respondents were no more than the agencies through which the State carried out its undertaking to manage and operate the railway. But the management and operation of the railway were no part of the functions of *government* of the Commonwealth of Massachusetts. Necessarily, therefore, the trustees exercised no governmental powers and were not

such agencies or instrumentalities of the State as are exempt from Federal taxation under any proper application of implied constitutional immunity.

The court below quoted only a portion of a sentence from the opinion of this Court in *Metcalf & Eddy* v. *Mitchell, supra* (p. 524), in support of the holding that an officer of either a State or the Nation is exempt from taxation by the other irrespective of the services performed or the nature of his employment. The complete sentence from which the quotation was taken is "any taxation by one government of the salary of an officer of the other, or the public securities of the other, or an agency created and controlled by the other, *exclusively to enable it to perform a governmental function* * * * is prohibited." (Italics ours.) The court below, in reproducing this sentence, omitted the words which we have italicized.

Nor does the holding of the court below receive any support from *Dobbins* v. *Commissioners of Erie County, supra,* and *The Collector* v. *Day, supra,* which were also cited. In the *Dobbins* case, Pennsylvania sought to tax the office, valued according to the salary, of a captain in the Federal Revenue Cutter Service. The tax was held invalid on the ground that an officer of the Revenue Cutter Service is an agency employed in the exercise of sovereign governmental powers of the Nation, namely, taxation and the regulation of interstate and foreign commerce. In the *Day* case, the Federal Govern-

ment sought to tax the salary of the judge of the Court of Probate and Insolvency for the County of Barnstable, Massachusetts. It was held that the Federal Government could not tax the salary of a judicial officer of the State for the reason that the judicial department is one of the sovereign rights and powers of the State and a judge is an instrumentality through which the State exercises such powers. In both the *Dobbins* and *Day* cases the officer whose salary was held immune from taxation was exercising essential governmental powers.

III

THE FACT THAT THE RESPONDENTS HAD THE POWER TO FIX RATES AND TO DECLARE DEFICITS WHICH WERE USED AS A BASIS OF TAXATION IS NOT SUFFICIENT TO EXEMPT FROM TAXATION THE SALARIES WHICH THEY RECEIVED FOR MANAGING THE RAILROAD

The respondents in their brief in opposition laid great stress on the fact that under the Special Act of Massachusetts they had the power to fix rates, and to declare deficits, which, upon certification to the proper officers of the Commonwealth, became the basis for the levy of taxes from the communities affected. We submit that the possession of these powers does not form an adequate basis for the decision below.

The basis upon which the rates were to be fixed was provided for in detail in the Act itself. See Secs. 6–11 (*infra*, pp. 39–42). Cf. *Cleveland Railway Co.* v. *Commissioner*, 36 F. (2d) 347 (C.C.A. 6th), certiorari denied, 281 U.S. 743. The trustees

were given substantially no discretion, and were not required to make determinations on questions involving the exercise of judgment, such as the valuation of the property. The trustees had no power to levy taxes. They could only certify the amount of any deficit to the Treasurer and Receiver General of the Commonwealth, a mere ministerial act.

The authority conferred upon the trustees in this respect was essentially the same as the authority conferred upon the company itself when private operation should be resumed. Sec. 15 of the Special Act (*infra*, p. 44).

Moreover, even if these powers could be considered as the exercise of essential powers of *government*, it would seem clearly not to follow that the salaries paid to the respondents would be exempt. The salaries were paid to the trustees *by the company* for their services as managers of the company and as agents of the company. This is made plain by the provision of the Act that "in the management and operation" of the company they "shall be deemed to be acting as agents of the company and not of the commonwealth." The salaries involved in this case were paid by the company, and it would seem to be clear that they were paid by the company as compensation for the services rendered by the respondents to the company. If the respondents exercised any essential governmental powers, they received no compensation on that account; and their compensation received for

managing the railroad can be no more exempt from taxation than would the private income of an individual be exempt because he was also a state judge.

In *Flint* v. *Stone Tracy Co., supra* (p. 152), this Court pointed out that in the cases where a state tax had been held invalid—

> the decision rested upon the proposition that the corporation was created to carry into effect powers conferred upon the Federal Government in its sovereign capacity, and the attempted taxation was an interference with the effectual exercise of such powers.

This Court in that case further said:

> In *Osborn* v. *The Bank, supra,* a leading case upon the subject, whilst it was held that the Bank of the United States was not a private corporation, but a public one, created for national purposes, and therefore beyond the taxing power of the State, Chief Justice Marshall, in delivering the opinion of the court, conceded that if the corporation had been originated for the management of an individual concern, with private trade and profit for its great end and principal object, it might be taxed by the State. Said the Chief Justice (p. 359):
>
> "If these premises [that the corporation was one of private character] were true, the conclusion drawn from them would be inevitable. This mere private corporation, engaged in its own business, with its own views, would certainly be subject to the tax-

ing power of the State, as any individual would be; and the casual circumstance of its being employed by the Government in the transaction of its fiscal affairs would no more exempt its private business from the operation of that power than it would exempt the private business of any individual employed in the same manner."

Even if the salary paid by the company could be regarded as paid in part as compensation for the powers exercised by the respondents on behalf of the State, it would not follow that the entire amount of the compensation would be exempt from Federal tax. Certainly the major part of the respondents' services were rendered on behalf of the company and their compensation for those services would not be exempt. If it is necessary or proper to allocate the compensation actually received between the two types of services (which we deny), then the respondents' case must likewise fail; for the burden of proof was on them, and they have produced no evidence of the proper basis of allocation. *Reinecke* v. *Spalding*, 280 U.S. 227. The fact that such an allocation would be difficult, or perhaps impossible, to make does not furnish any basis for the respondents' contention that the entire salary should be exempt. *Burnet* v. *Houston*, 283 U.S. 223.

CONCLUSION

The instant case presents a striking instance of that necessity observed by the Court in *South Caro-*

lina v. *United States, supra,* for confining the doctrine of implied constitutional immunity within appropriate bounds and limiting its application to those agencies which are of a strictly governmental character. The management and operation of the railway was not an essential governmental activity of the Commonwealth of Massachusetts, and the respondents as trustees, were not officers, agencies, or instrumentalities exercising essential powers of government. A tax upon the compensation received by the respondents, which was paid by the company and not by the State, imposed no burden upon the State and in no degree interfered with the free and unrestricted power of the State to employ agencies exclusively for the discharge of its strictly governmental functions. It would seem clear, therefore, that the doctrine of implied constitutional immunity is not applicable here and the compensation received by the respondents is subject to the Federal income tax.

We respectfully submit that the decision of the court below is erroneous and should be reversed.

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SEPTEMBER 1934.

APPENDIX A

Revenue Act of 1926, c. 27, 44 Stat. 9:

> SEC. 212. (a) In the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by sections 214 and 206.
>
> * * * * * *
>
> (U.S.C. App., Title 26, Sec. 953.)
>
> SEC. 213. For the purposes of this title, except as otherwise provided in section 233—
>
> (a) The term "gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property * * * or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period.
>
> * * * * * *
>
> (U.S.C. App., Title 26, Sec. 954.)

Revenue Act of 1928, c. 852, 45 Stat. 791, 797:

Sections 21 and 22 (a) of the Revenue Act of 1928, so far as material, are substantially the same as

Sections 212 (a) and 213 (a), respectively, of the Revenue Act of 1926, as set forth above.

Treasury Regulations 69, promulgated under the Revenue Act of 1926:

> ART. 88. *Compensation of State officers and employees.*—Compensation paid to its officers and employees by a State or political subdivision thereof for services rendered in connection with the exercise of an essential governmental function of the State or political subdivision, including fees received by notaries public commissioned by States and the commissions of receivers appointed by State courts, is not taxable. Compensation received for services rendered to a State or political subdivision thereof is included in gross income unless (*a*) the person receives such compensation as an officer or employee of a State or political subdivision, and (*b*) the services are rendered in connection with the exercise of an essential governmental function. But see section 1211 as to 1924 and prior years.

Article 643 of Treasury Regulations 74 and 77, promulgated under the Revenue Acts of 1928 and 1932, so far as material, is substantially the same as Article 88 of Regulations 69, set forth above.

APPENDIX B

Massachusetts, Special Acts and Resolves, 1918:

CHAP. 159. AN ACT TO PROVIDE FOR THE PUBLIC OPERATION OF THE BOSTON ELEVATED RAILWAY COMPANY

Be it enacted, etc., as follows:

SECTION 1. The board of trustees of the Boston Elevated Railway Company is hereby created, to consist of five persons to be appointed by the governor, with the advice and consent of the council. The persons so appointed shall be sworn before entering upon the performance of their duties; shall own no stock or other securities of the Boston Elevated Railway Company or of any company owned, leased or operated by it; shall serve for the term of ten years from the date when they assume the management of the company as hereinafter provided and until their successors are duly appointed and qualified, and each shall receive from the company as compensation for his services five thousand dollars annually. In case of any vacancy in said board by reason of death, resignation, or otherwise, the governor, by and with the consent of the council, shall fill the vacancy. The board shall designate one of the trustees so appointed to serve as chairman. Any member of the board may be removed for cause by the governor, with the advice and consent of the council.

Said trustees shall not be considered public officers within the meaning of section twenty-five of chapter five hundred and fourteen of the acts of nineteen hundred and nine, but shall be subject in all other respects to the provisions of said section to the same extent as are the directors of the Boston Elevated Railway Company, but said section shall not apply to recommendations by the governor to said trustees. The provisions of section one of chapter seven of the Revised Laws shall not apply to the said board.

If the public management and operation of the railway system of the Boston Elevated Railway Company shall continue beyond the original period of ten years the governor shall, with the advice and consent of the council, at the expiration of each ten-year period during the continuance of public management and operation, appoint five successor trustees to serve for a period of ten years and until their successors are appointed and qualified, but not exceeding the period of public management and operation. Said trustees shall assume the management and operation of the company's property on the first day of the month next following their appointment and qualification.

SEC. 2. Said board of trustees, hereinafter called the trustees, shall manage and operate the Boston Elevated Railway Company hereinafter called the company, and the properties owned, leased, or operated by it, for a period of ten years, commencing on the first day of the month next after their appointment and qualification, and, subject to the provisions of this act, shall take and have possession of said properties in behalf of the commonwealth during the period of public

operation, and, for the purposes of this act, shall, except as is otherwise provided in this act have and may exercise all the rights and powers of said company and its directors, and, upon behalf of said company, shall receive and disburse its income and funds. They shall have the right to appoint and remove in their discretion the president, treasurer, and clerk of the corporation, and all officers of the company other than the board of directors. They shall have the right to regulate and fix fares, including the issue, granting and withdrawal of transfers, and the imposition of charges therefor, and shall determine the character and extent of the service and facilities to be furnished, and in these respects their authority shall be exclusive and shall not be subject to the approval, control, or direction of any other state board or commission.

In the management and operation of the said company and of the properties owned, leased, or operated by it, as authorized by this act, the trustees and their agents, servants, and employees shall be deemed to be acting as agents of the company and not of the commonwealth, and the company shall be liable for their acts and negligence in such management and operation to the same extent as if they were in the immediate employ of the company, but said trustees shall not be personally liable. A majority of the board shall constitute a quorum for the transaction of business, and the action of a majority of those present at any meeting shall be deemed the action of the trustees.

Nothing herein contained shall be held to affect the right of the commonwealth or any subdivision thereof to tax the company or its stockholders in the same manner and to

the same extent as if the company had continued to manage and operate its own property.

SEC. 3. The trustees shall have authority to make contracts in the name and on behalf of, and to issue stocks, bonds, and other evidences of indebtedness of, the company. * * * The trustees shall cause to be paid all amounts which may from time to time become due from the company, and shall declare dividends at the appointed times upon the preferred and common stock of the company, and provide for the payment of the same.

* * * * * *

SEC. 5. The Boston Elevated Railway Company shall, prior to or at the time of its acceptance of this act, provide for raising three million dollars in cash by the issue of preferred stock at not less than the par value which shall be one hundred dollars per share. * * *

One million dollars shall be set aside as a reserve fund to be used only for the purposes hereinafter specified, and the remaining two million dollars shall be subject to the disposition of the trustees to pay for the cost of additions and improvements to the company's property.

SEC. 6. The trustees shall from time to time, in the manner hereinafter provided, fix such rates of fare as will reasonably insure sufficient income to meet the cost of the service, which shall include operating expenses, taxes, rentals, interest on all indebtedness, such allowance as they may deem necessary or advisable, for depreciation of property and for obsolescence and losses in respect to property sold, destroyed, or abandoned, all other expenditures and charges which under the laws of the commonwealth

now or hereafter in effect may be properly chargeable against income or surplus, fixed dividends on all preferred stock of the company from time to time outstanding, and dividends on the common stock of the company from time to time outstanding at the rate of five percent per annum on the par value thereof during the first two years, five and one-half percent per annum on the par value thereof during the next two years and six percent per annum on the par value thereof during the balance of the period of public operation. * * *

SEC. 7. The trustees shall, within sixty days after their appointment and qualification, fix and put in operation rates of fare which in their judgment will produce sufficient income to meet the cost of the service as defined in section six, and within sixty days thereafter shall adopt and publish a schedule of eight different grades of fare, of which four shall be below and four above the rate of fare first established; and whenever by reason of any change in the existing rate of fare there are less than four grades, either above or below the rate then in force, the trustees shall forthwith adopt and publish a schedule of additional grades of fare so that there shall always be not less than four grades of fare above and below the existing rate of fare.

If at any time the trustees shall be of opinion that said rates of fare or schedule should be changed, either with regard to the method or basis upon which the fares and transfer privileges are established, or because the steps between the different grades are too small or too great, or for any other reason, the trustees may adopt, publish, and put in effect new schedules or rates of fare to take

the place of the existing schedule or rates of fare.

SEC. 8. The reserve fund shall be used only for the purpose of making good any deficiency in income as provided in section nine or for reimbursing the commonwealth as provided in sections eleven and thirteen, and until such use, may be invested in income-producing securities in the discretion of the trustees, and all income or interest received thereon shall be treated as part of the general income of the company.

SEC. 9. Whenever the income of the company is insufficient to meet the cost of the service as herein defined, the reserve fund shall be used as far as necessary to make up such deficiency, and whenever, on the other hand, such income is more than sufficient to meet the cost of the service, the excess shall be transferred to and become a part of the reserve fund.

SEC. 10. If, as of the last day of June in the year nineteen hundred and nineteen, or the last day of any September, December, March, or June thereafter, the amount of the reserve fund shall exceed by thirty percent or more the amount originally established, and during the preceding three months the income shall have exceeded the cost of the service, the trustees shall within one month thereafter put into effect the next lower grade of fare that has been adopted as provided in section seven; and if, as of any such last day of June, September, December, or March, the amount of the reserve fund shall be less than seventy percent of the amount originally established and during the preceding three months the income has been less than the cost of the service, the trustees shall within one month thereafter put into effect the next higher grade of fare, and the

fare shall continue to be decreased or increased, as the case may be, subject to the same conditions, if the amount of the reserve fund is above or below said limits, as of such quarterly dates. In determining the amount of the reserve fund for the purposes of this section only there shall first be deducted therefrom any amounts which have been paid by the commonwealth to the company under the provisions of section eleven, and for which the commonwealth has not been reimbursed.

SEC. 11. If, as of the last day of June in the year nineteen hundred and nineteen, or the last day of any December or June thereafter, the amount remaining in the reserve fund shall be insufficient to meet the deficiency mentioned in section nine, it shall be the duty of the trustees to notify the treasurer and receiver general of the commonwealth of the amount of such deficiency, less the amount, if any, in the reserve fund applicable thereto, and the commonwealth shall thereupon pay over to the company the amount so ascertained. Pending such payment it shall be the duty of the trustees to borrow such amount of money as may be necessary to enable them to make all payments, including dividend payments, as they become due. If, as of the last day of any June or December thereafter during the period of public operation, the reserve fund shall exceed the amount originally established, the trustees shall apply the excess, so far as necessary, to reimbursing the commonwealth for any amounts which it may have paid to the company under the provisions hereof, and the commonwealth shall thereupon distribute the amount so received among the cities and towns in which the company operates, in proportion to the

amounts which they have respectively been assessed as provided in section fourteen.

In order to meet any payment required of the commonwealth under the provisions of this section the treasurer and receiver general may borrow at any time, in anticipation of the assessments to be levied upon the cities and towns, such sums of money as may be necessary to make said payments, and he shall repay any sums so borrowed as soon after said assessments are paid as is expedient.

* * * * *

SEC. 13. It shall be the duty of the trustees to maintain the property of the company in good operating condition and to make such provision for depreciation, obsolescence and rehabilitation, that, upon the expiration of the period of public management and operation, the property shall be in good operating condition. If the period of public management and operation expires, control of the property shall then revert to the company, and if at that time the reserve fund shall be less than the amount originally established because the income during the period of public management and operation has been insufficient to pay the cost of the service, the commonwealth shall forthwith pay over to the company an amount sufficient to restore it to its original amount; and if the amount in said reserve fund is then in excess of the amount originally established and any amount required to meet the cost of the service to the expiration of such period, such excess shall be paid into the treasury of the commonwealth and distributed among the cities and towns in which the company operates in the same proportions as the assessments provided for by section fourteen.

SEC. 14. In case the commonwealth shall be called upon to pay to the trustees or the company any amount under the provisions of sections eleven and thirteen, such amount with interest or other charges incurred in borrowing money for the purpose shall be assessed upon the cities and towns in which the company operates by an addition to the state tax next thereafter assessed in proportion to the number of persons in said cities and towns using the service of the company at the time of said payment, said proportion to be determined and reported to the treasurer and receiver general by the trustees from computations made in their discretion for the purpose.

SEC. 15. Upon the termination of the period of public management and operation, the company shall manage and operate the property and may fix and collect such just and reasonable fares as will produce an income sufficient to pay the reasonable cost of the service as defined in section six, including dividends upon the common stock from time to time outstanding of six percent per annum on the par value thereof but no more, and may establish schedules of fares which shall automatically increase or decrease in the same manner as is authorized in the case of the trustees: *Provided*, that the commonwealth shall be under no liability to make any payments to the company by reason of any deficiencies in income accruing after the discontinuance of public operation. The company shall thereafter be subject to public regulation and supervision in such manner as may be determined by the general court, but such regulation and supervision shall not be exercised so as to reduce the income below

the reasonable cost of the service as defined in this act.

* * * * *

SEC. 18. With the exception of section five, which shall take effect upon the passage of this act, this act shall take effect upon its acceptance by the holders of not less than a majority of all the stock of the Boston Elevated Railway Company and by the holders of not less than a majority of all the stock of the West End Street Railway Company, given at meetings called for the purpose, and the filing of certificates of acceptances with the secretary of the commonwealth, and the filing with the said secretary of a certificate, signed and sworn to by a majority of the directors of the Boston Elevated Railway Company, that the entire three million dollars of preferred stock provided for by section five has been subscribed for, and at least thirty percent of his subscription has been paid in in cash by each subscriber, and that no dividends have been declared or paid upon the company's common stock since the passage of this act.

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